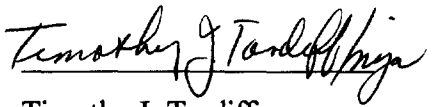


of \$0.07 for the essential input and \$0.06 to use its own network) on each of the 13.6 billion minutes it sells, the resulting margin of \$136 million falls short of its fixed costs.

10. The alternative provider cannot recover its fixed costs because it is less efficient. While the BOC's incremental cost remains at \$0.10 per minute as long as it must produce the essential input, the alternative provider's cost is \$0.112 per minute. Therefore, a more efficient provider has not been excluded from the market. Rather, by lowering prices, consumers have benefited and production costs have decreased. MFS's examples merely illustrate an inefficient provider surviving under a price umbrella in Table 1.
11. MFS recommends that the BOC provide the essential input at incremental cost (\$0.03 per minute in its examples). The implication of this is that the BOC would have to recover its fixed costs totally in the price of its competitive services. In MFS's examples, the BOC's output is under 3 billion minutes. Accordingly, MFS's prescription would require a mark-up of over \$0.10 per minute. The consequence would be that either the alternative provider would enjoy an extremely high price umbrella or the BOC would be driven out of the market for the competitive service.
12. Suppose the latter occurs and the market is competitive, i.e., alternative providers earn no excess margin. Using the demand response implicit in MFS's example, I estimate that the alternative providers would charge a price of about \$0.105 per minute and would produce 19.8 billion minutes. Even at this volume, the alternative provider's unit cost of about \$0.105 per minute is higher than the BOC's incremental cost.
13. Of course, the BOC could not survive if it were driven out of the competitive market and were not allowed to recover any of its fixed costs in the price of the essential input. If after exiting the competitive market, the regulator allowed the ILEC to recover only its forward-looking fixed cost, which would become part of the total element long run incremental cost (TELRIC) or the essential input, then the price of the essential input would have to be marked up accordingly. For example, an essential input price of \$0.053 and a market price of \$0.131 for the competitive service would allow both the BOC and the alternative provider to recover their costs at a volume of 17 billion minutes. But even here, the competitor's incremental cost is higher than if the BOC had been allowed to remain in the competitive business.

14. There is a volume at which the alternative provider in MFS's example becomes more efficient. For example, if the alternative provider can produce 40 billion minutes, its average cost per minute is \$0.0975, which is less than the BOC's cost of \$0.10 per minute. Under these circumstances, the imputation rule permits such an efficient competitor to prosper. For example, if the imputation price floor were \$0.14 per minute as in Table 2, the alternative provider would realize a margin of \$100 million. Alternatively, it could lower its price and expand its market share.
15. In conclusion, these examples show that imputation safeguards, properly applied, prevent a BOC from obtaining a competitive advantage in vertical markets. Done correctly, MFS's illustration shows that imputation works, in the sense that the competitor having the lowest cost service is able to reflect its cost advantage by charging the lowest price.


Timothy J. Tardiff

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I, Lea Ann M. Hauck, do hereby certify that on this 30th day of August, 1996,
I have caused a copy of the foregoing **REPLY COMMENTS OF U S WEST, INC.**
to be served via first-class United States Mail, postage prepaid upon the persons
listed on the attached service list.

A handwritten signature in cursive script, reading "Lea Ann M. Hauck", written in black ink.

Lea Ann M. Hauck

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